COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

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Bay State Gas Company	)	**D.T.E.** 05-27
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INITIAL BRIEF OF THE

MASSACHUSETTS DIVISION OF ENERGY RESOURCES

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I. INTRODUCTION AND PROCEDURAL HISTORY

On April 27, 2005, Bay State Gas Company ("Bay State" or the "Company") filed with the Department of Telecommunications and Energy (the "Department") a petition pursuant to G.L. c. 164, § 94 for approval of a 22.2 million dollar increase in its base rates for firm gas customers. The petition also includes a request for approval of a price cap performance base rate ("PBR") plan under which the Company proposes to adjust its rates annually for five years, an Earnings Sharing Mechanism ("ESM") as well as approval of a steel infrastructure replacement ("SIR") adjustment to provide for annual recovery of steel infrastructure replacement investments.

The Department docketed the petition as D.T.E. 05-27. The Massachusetts Division of Energy Resources ("DOER") filed a timely Motion to Intervene on May 26, 2005, which was granted by the Department on June 2, 2005.

Pursuant to notice duly issued on April 29, 2005, the Department held public hearings on May 25, May 26, and May 31. The Attorney General of the Commonwealth filed a notice of intervention as of right in the proceeding and the following parties filed Motions to Intervene and/or for Limited Participation in the proceeding, which were granted by the Department: Western Mass Electric Company, MASSPOWER, NStar, Associated Industries of Massachusetts, UWUA Local 273, United Steelworkers of America, KeySpan Energy Delivery Service New England, New England Gas Company, Massachusetts Association for Community Action, Massachusetts Energy Directors Association, Mass Oilheat Council, Fitchburg Gas & Electric, and Berkshire Gas Company.

On June 2, 2005, the Department conducted a procedural conference and established dates for discovery, evidentiary hearings, and the submission of briefs. On July 15, 2005, pursuant to the procedural schedule, DOER submitted the expert testimony of Dr. Alvaro E. Pereira concerning the Company's proposed PBR, Earnings Sharing Mechanism (ESM), and charge for dual fuel customers. DOER's participation in the evidentiary portion of this proceeding has been limited to these issues. Dr. Pereira also submitted oral surrebuttal testimony on August 10, 2005.

II. SUMMARY OF DOER POSITION

DOER supports the application of PBRs in lieu of traditional cost of service rate setting when appropriate. DOER applauds the Department's continued examination of this approach and shares its view that PBR rate setting is preferable. As we are sure the Department recognizes, however, each application has to be examined based on the particular circumstances of the utility, and the applicant has the burden of showing that its treatment under a PBR mechanism fits that applied to others. The circumstances of this case are a good example of how critical that examination is in ensuring the integrity of the Department's PBR precedent. Allowing utilities to merely file "me too" proposals, or worse, selectively picking components of a PBR, will result in a distortion of the goals and objectives so clearly determined in earlier cases. That is exactly the problem presented in this case. As indicated in Dr. Pereira's testimony, and supported in large part by the Company's own witness, Bay State has not met the standards set for a PBR in prior cases and has attempted to contort that precedent to fit its circumstances. DOER urges the Department to reject the proposed PBR and ESM unless modified as presented below. We also urge the Department to reject the SIR. Bay State should decide what it wants, a PBR or cost of service rates. There should be no combo option. Finally, DOER urges rejection of the charge for dual fuel customers.

III. STANDARD OF REVIEW

The Department has established that because PBR plans act as an alternative to traditional cost of service regulation, they are subject to the standard of review established by G.L. 164, § 94, which requires rates to be just and reasonable. D.P.U. 94-158, at 52-66. A company seeking approval of an incentive proposal is required to demonstrate that its approach is more likely than current regulation to advance the Department's traditional goals of safe, reliable and least-cost energy service and to promote the objectives of economic efficiency, cost control, lower rates, and reduced administrative burden in regulation. Id. at 57.

Well-designed incentive mechanisms should provide utilities with greater incentives to reduce costs than those which exist under traditional COS/ROR regulation. The Department's Order in 94-158 identifies the following criteria that a petitioner seeking approval of an incentive proposal must demonstrate:

- Consistency with Department regulations, statutes, and governing precedent;
- Consistency with market-based regulation and enhanced competition;
- Safeguard system integrity, reliability and current policy objectives;
- Rewards utility performance and addresses exogenous costs;
- Focus on comprehensive results;
- Incorporates well-defined, measurable indicators of performance;
- Consistent with accounting standards and acceptable within the financial community.

Id. at 58-64.

In Docket No. 03-40, the Department applied these standards to an incentive mechanism proposed by Boston Gas Company. Boston Gas proposed a PBR plan which included: a price cap formula; term; earnings sharing mechanism; adjustments for exogenous costs; rate design and pricing flexibility; service quality; and annual compliance filing. D.T.E. 03-40, at 471. Boston Gas proposed a price-cap formula which included: an inflation index; and a productivity offset, which consisted of a productivity differential, an input price differential, a consumer dividend, and an exogenous cost factor.

For the reasons presented below, the PBR proposed by Bay State is not consistent with the Department's decisions in 94-158 or 03-40. By removing a significant portion of its future capital costs and limiting its application to largely "sunk" capital costs and O&M, it is not a comprehensive PBR. Bay State has no record support for its proposal based on Boston Gas precedent. They have not proposed the same mechanism; therefore the precedent does not apply. The Bay State proposal must be rejected because it does not promote the Department's objectives of economic efficiency, cost control, lower rates, and reduced administrative burden in regulation.

IV. BSG'S PBR PROPOSAL IS NOT CONSISTENT WITH DEPARTMENT PRECEDENT AND MUST BE REJECTED OR MODIFIED

A. BSG's Proposal Does Not Include Total Costs and is Therefore Inconsistent with Department Precedent

In Boston Gas 03-40, the Department established a PBR formula based upon a performance study of the utility in all cost areas, both capital and O&M. The purpose of such as study is to establish a benchmark of performance from which the utility would have the incentive to improve. By managing costs within in its revenue cap yet continue to meet its service obligations within or better than industry standards, the utility has the opportunity to earn greater revenues and avoid repeated rate filings. It is that performance study from which the Department established the components of the formula, particularly the X factor used to address productivity improvements. As explained by Dr. Kaufmann, Bay State's witness, the Company has proposed a PBR mechanism that is based upon a study of O&M costs only and, therefore, on its face, does not match the circumstances of the Boston Gas case.

In Exhibit No. DTE-4-10, Dr. Kaufmann explained that the total cost study performed by him yielded results "markedly inferior" to those presented by the O&M only study. In hearing Dr. Kaufmann elaborated, "So our presumption always going into a study like this is to undertake the most comprehensive analysis of the company's performance that we can…..Most of the work that we've done, most of the work that we did, for Bay State for the cost model was a total-cost model." Tr. 761. But Dr. Kaufmann ran into problems with the capital additions and the "vintaging" issue. Ibid. He concluded, "So at that point I realized that I couldn't satisfy the standard that was laid out in 03-40. So we abandoned the cost model." Tr. 763.

Dr. Pereira has posited why the total cost model did not perform well. In Exhibit DTE-DOER-1-6, Dr. Pereira analyzed the capital cost data of the Company as compared to the industry, consistent with the way the PCI component of the PBR formula works. His analysis showed that capital spending of the Company during the period of the previous rate freeze actually rose significantly, particularly as compared to the industry. The average growth rate for Bay State in capital spending was four times that of the industry average. Ibid. As stated by Dr. Pereira, his analysis gives some indication that with respect to capital cost incurrence, the Company "is actually a little worse than an average cost performer." Tr. 2875. Taken into consideration with Dr. Kaufmann's O&M study indicating the Company to be a superior performer, the evidence suggests that the Company has substituted capital for labor during the period of the price freeze. Tr. 2872. Consequently, not only has the Company proposed an approach that is inconsistent with Department precedent, it has developed a hybrid which could provide the absolutely wrong incentives to a utility to the detriment of customers.

In sum, the Company acknowledges that they cannot meet the requirements of the Boston Case and thus set out to try and fit its case into the Boston Gas mold.

They did this in two ways, first by limiting the application of the PBR formula adopted in that case to the "cast off" rates yielded from O&M, sunk capital costs and future non-SIR capital costs only; and second, by segregating out the SIR costs for separate rate treatment. The result is the best of both worlds on a total cost basis: application of a PBR on existing costs, even though the Company's management of non-O&M costs appears to be average at best, and cost of service for the costs that are uncertain going forward.

In defense of this approach the Company presents essentially two arguments: first that the SIR costs are somehow special and should be treated differently and two, that a PBR applicable to sunk and non-SIR capital costs will be effective in managing costs and meet the objectives of the Department. We disagree that these reasons support the proposal. With respect to the capital costs subject to the PBR, Dr. Kaufmann himself stated, "Most such costs reflect capital investment decisions that were made in the (often distant) past and which current managers cannot undo." Exhibit No. DTE-4-2. On rebuttal, however, Dr. Kaufmann backed away from that statement and stated that these costs were manageable. Exhibit No. BSG-Rebuttal-5 at page 4-5. He disputes Dr. Pereira's contention that the PBR will be ineffective in influencing the Company's activities in this regard. Dr. Pereira, however, does not dispute these contentions. He had relied on Dr. Kaufmann's statements in making his statements. Tr. 3982. The issue, however, is not whether the costs are manageable but whether the full benefits of the PBR formula are appropriate with these limitations on its applicability and in light of the infirmities in the total cost study. As described more fully below, DOER's position is that the formula should be modified to reflect the limits of the costs covered by the PBR and, further, the SIR adjustment mechanism should be rejected.

B. The PBR Formula Should be Tailored to Better Match the Costs Subject to the PBR

There are alternatives to addressing the problems posed by the facts of this case. If the total cost study does not yield reliable indications of the applicability of the total cost PBR, then the PBR must be modified to reflect the exclusion of the new capital costs (SIR and non-SIR), particularly since Dr. Pereira's analysis suggests that the Company is not a superior performer in this cost area. Dr. Pereira has proposed that the formula be modified to essentially apply only to the percentage of the Company's costs that are O&M related. Exhibit No. DOER-1 at page 7. This PBR calculation reduces the growth rate reflected in the PCI component of the formula by roughly a half (48.5%), which is the approximate portion of costs that are O&M.[1] This would be the appropriate adjustment regardless of how the Department rules on the SIR adjustment since the evidence does not support allowing the application of the same PBR for O&M to any other costs of the Company.

There was much discussion during the hearing of developing a separate PBR for capital costs which might have different inputs, such as a higher customer dividend to reflect the poorer performance by the Company on the capital cost management. Tr. 4003-4005. There is insufficient information in the record, however, to develop such a PBR and, since the company

[1] For a detailed description of the Pereira rate formulation, see Exhibit No. DOER-AEP-2 and Tr. 3984-3986.

has the burden of proof in this case, the Department should not reach to fix the problems in the Company's proposal. The simple solution is to modify the formula and leave the remaining capital costs not in the cast-off rates effectively subject to a rate freeze. Exhibit No. DOER-1 at page 7, lines 23-25. As stated by Dr. Kaufmann, "a rate freeze is a perfectly acceptable form of PBR." Tr. 738.

C. The SIR Mechanism Must be Rejected

As discussed previously, the SIR adjustment mechanism is designed to carve out certain so called "non-discretionary" capital costs for annual recovery on a cost of service basis and a filing with the Department. Exhibit BSG-SHB-1, page 39. This proposal is not only a distortion of the PBR approach because it segregates costs for different treatment, but is also a distortion of traditional cost of service regulation. It is well established Department precedent, and indeed lore of decades of rate regulation, to look at the total cost of a utility before allowing rate increases. While some costs rise, others may fall and revenues usually increase to offset at least a portion of those cost increases. Here, as noted above, the Company has suggested special treatment for one category of costs which is not justified by the evidence.

In an attempt to rebut Dr. Pereira's proposal for an O&M only PBR, Dr. Kaufmann describes ways in which the company can be influenced by the PBR on sunk and non-SIR capital costs. He cites economies of scale which can lower the unit of costs as output expands. Exhibit BSG-Rebuttal-5, page 4, line 22- page 5 lines 1-10. There is no reason why the Company cannot take the same measures with respect to the SIR costs. Tr. 3983. All costs of the Company should be incurred to provide reliable and economic delivery of service to customers or they should not be incurred in the first place. Ibid. The impact on rates is significant and must be put in perspective. The projected annual rate increase under the proposed SIR is roughly $6M. Exhibit

BSG/JAF-2, page 27, lines 26-18. Over the 5 year period proposed by the Company, the SIR costs alone will increase rates by 20% for a typical residential customer.[2]

To say that the SIR costs are different makes no sense and is not supported by the record. As stated by Dr. Pereira, to allow the proposed PBR in conjunction with the SIR mechanism would be a step backwards in the realm of incentive regulation. Exhibit DOER 1, at page 3, line 27. The inclusion of the SIR with the PBR proposal undermines all of the benefits of the PBR and distorts the objectives of the PBR set out by the Department. There will be no reduction in rate case expense since there will still be annual filings subject to prudence review and audit by the Department and others. There will be less rate certainty for customers since the amounts will be largely unknown. What makes sense is to keep this Company on course toward a full total cost PBR. To do that, the Department should subject capital costs to a rate freeze and O&M costs to a modified PBR formulation.

V. <u>The Parameters of the Proposed ESM Are Too Broad and Should be Modified to Provide Greater Opportunity For Customer Benefit</u>

An Earnings Sharing Mechanism (ESM), while a separate mechanism from the PBR, is often applied in conjunction with a PBR to ensure that the company does not earn excessive returns during the extended period of the rate plan. It also allows customers to share in the benefits of the PBR. DOER-1 at page 8. Initially, the Company proposed the same ESM as adopted by the Department for Boston Gas. They provided no other basis for the proposal. Under this proposal, the Company would retain all earnings 400 basis points above its allowed rate of

[2] Based on the Company's data response to DOER-1-9, Attachment DOER-1-9 (b), page 1, the Company shows a bill impact due to SIR Base Rate Adjustment of $20 for a typical residential heating customer (R-3) on line 37. Dividing that figure by the test-year base rate amount for this rate class of $511 (line 24) yields a rate increase of 3.8%. Five years of rate increases of $20 per year results in an increase of approximately 20% over test year bills (100/511).

return. This ESM is the most heavily tilted toward shareholders than any of the ESMs adopted by other jurisdictions surveyed by DOER. See, DOER-AEP-1. DOER's survey was not rebutted by the Company.

As described by Dr. Pereira, an ESM should reflect the potential for savings and the difficulty for achieving those savings. Ibid. at lines 19-20. It should also reflect the risks to the company in earning its allowed rate of return. These are all Company specific determinations not evaluated by the Company in proposing the 400 basis point spread. In this case, there are several reasons why it is not appropriate. On rebuttal, Dr. Kaufmann recommended a modification to the proposal, suggesting a reduction in the spread to 200 basis points and a sharing with customers of 50/50 above that amount. Exhibit BSG/Rebuttal-5, page 10 at lines 23-25. He also suggested that the Department establish a cap and floor to provide further protection to both the Company and customers. He suggested an earnings floor of 6.5% and a cap of 500 basis points above the allowed rate of return. Id. at page 11, lines 11-15. While a significant overture by the company, it is still too generous under the circumstances.

As discussed by Dr. Pereira, the O&M study performed by Dr. Kaufman indicates that this Company is a superior cost performer with respect to O&M costs. Tr. 3991. According to Dr. Kaufman, these types of costs yield the greatest potential for greater savings. Exhibit DTE-4-2. For a Company that has already achieved significant savings from the effects of a rate freeze, they should be given an incentive to reach for greater, perhaps more difficult savings. But at the same time, customers should have some opportunity to share in the benefits of these savings. Achievement of greater savings require the Company to stretch for more innovative solutions. Dr. Pereira supports some level of threshold where the Company may receive 100% of the savings, such as 50 basis points, but beyond that, there should be sharing. He has suggested 75%

to customers and 25% to shareholders in the 51-200 basis point range and then flipping the sharing to 75% shareholders and 25% customers beyond 200 basis points. Ibid.

It's important to consider this issue in the context of real numbers and what the mechanism means from a practical standpoint. In Exhibit DTE-DOER – 1- 9, Dr. Pereira examines what level of savings the Company would have to achieve before customers would share in the benefits. Even under Dr. Kaufmann's revised 200 basis point spread, customers would not receive any benefit until the Company cut costs by $4.3M. That is roughly 25% of the proposed revenue increase in this case. In evaluating the proposal, the Department should consider the likelihood of the company reaching that cost saving level and whether customers would ever receive any benefit from those cost cuts. DOER believes that the potential for the company achieving cost cuts much beyond that after five years of a rate freeze, when significant cost savings were achieved after its merger with NiSource, are highly unlikely. Consequently, the ESM must be formulated so as to incent and share.

VI. THE SPECIAL PROVISION FOR DUAL FUEL CUSTOMERS SHOULD BE REJECTED

In this filing, the company proposes a new charge for customers with dual fuel capability. M.D.T.E. 67. This special provision has been proposed ostensibly to recover fixed costs from these customers when they are using alternative fuels. According to Mr. Ferro, this provision is needed to ensure cost recovery and prevent cost shifting to other customers. Exh. BSG/JAF-3, page 3-5. Mr. Ferro states that such customers "escape cost responsibility" when they use alternative fuels, since the service charges are premised on firm continuous usage. Any under-recovery of costs by the Company is shifted to other customers. Ibid. Other than mere assertions, the Company has provided no evidentiary support for this new charge. They have not provided any cost data showing such cost shifting. They have not provided any forecasts of the revenues that may arise under this new provision. This provision should be rejected. It is not supported by the evidence.

From a policy perspective, even with such cost and revenue support, the Department should also investigate the impact of such a charge on the broader energy policy implications. As pointed out by Dr. Pereira, dual fuel customers are most likely to switch fuels when the cost of natural gas is higher than alternatives. That tends to be in the winter heating season. "The gas that is displaced could then be used for other customers, thereby reducing the need for the company to purchase supplies at potentially high prices during peak times." Exh. DOER–1, page 11. Consequently, not only has the Company not shown that costs are shifted to other customers, but, in fact, under these circumstances, the dual fuel customer might actually be providing a benefit to firm customers on the system.

VI. **FINDINGS OF FACT AND CONCLUSIONS OF LAW**

Accordingly, DOER requests that the Department make the following findings of fact and conclusions of law with respect to the Bay State petition:

1. Application of a PBR mechanism is appropriate in this case in lieu of cost of service ratemaking.
2. Bay State has not shown that the PBR formula adopted by the Department in Docket 03-40 is appropriate for rates established in this case since the total cost study yielded unreliable results.

3. The PBR formula established by the Department in Docket 03-40 is appropriate for Bay State if applied to O&M expenses but only with modification. The appropriate modification is to reduce the growth rate in the PCI component of the formula by a multiplier of 0.485.
4. All capital costs, sunk and future, should be subject to a rate freeze.
5. The proposed SIR adjustment has not been shown to be just and reasonable and should be rejected.
6. The proposed ESM should be rejected as not just and reasonable. The proposal does not provide the company with sufficient incentive to reduce costs sufficiently to provide any ratepayer benefits.
7. The ESM should be modified to provide the company the opportunity to retain 100% of the increased revenues associated with the first 50 basis points earned above the allowed rate of return. Thereafter, there should be a sharing of the next 51-200 basis points as follows: 75% ratepayers and 25% shareholders and 75% shareholders and 25% ratepayers for amounts above 200 basis points.
8. The proposed rate schedule M.D.T.E. 67 for dual fuel customers has not shown to be just and reasonable and should be rejected.

Respectfully submitted,

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